

# HKFRS 15

## How the new standard affects revenue recognition of Hong Kong real estate sales before completion

### Introduction

HKFRS 15 *Revenue from Contracts with Customers* was issued by the Institute in 2014. HKFRS 15 is identical to IFRS 15 of the same title in all aspects and accordingly, references in this article to HKFRS 15 are equally applicable to IFRS 15. IFRS 15 was mandatorily effective for annual periods that begin on or after 1 January 2017. At its July meeting, the IASB confirmed a one-year deferral of IFRS 15 to 1 January 2018. The formal amendment to HKFRS 15, specifying the new effective date, is expected to be issued in September 2015. Entities can apply HKFRS 15 early if they wish to do so.

The scope of HKFRS 15 is broad and covers all contracts with customers, subject to a few exceptions such as leases and insurance contracts, which are covered by other standards. Once effective, HKFRS 15 will supersede the existing revenue standards, HKAS 18 *Revenue* and HKAS 11 *Construction Contracts*, as well as a number of related interpretations. Among them, HK(IFRIC) Interpretation 15 *Agreements for the Construction of Real Estate* is of particular relevance to real estate developers.

This article specifically deals with the common situation in Hong Kong where developers construct or cause to be constructed multi-storey residential buildings with multiple units and enter into sale and purchase agreements in respect of such units with customers in a mass retail market before the construction is complete (hereinafter referred to as "pre-completion sales").

Currently, before the application of HKFRS 15, real estate pre-completion sales in Hong Kong are generally recognized at a single point in time in accordance with paragraphs 16–19 of HK(IFRIC) Interpretation 15, i.e. as a "sale of goods."

HKFRS 15 adopts a new approach in determining when and how consideration from contracts with customers should

be recognized as revenue, regardless of whether companies label the contracts as, e.g. construction contracts or sale of goods contracts. In this regard, this article addresses the following two questions:

- **Question 1:** Should developers recognize consideration from pre-completion sales as revenue at a point in time (e.g. at the time of delivery of the completed unit to the customer) or over time (e.g. while the construction is still in progress using the percentage of completion method)?
- **Question 2:** If it is determined that consideration should be recognized as revenue at a point in time, at which particular point in time should developers recognize revenue?

For the sake of those readers not familiar with the pre-completion sales practices in Hong Kong and/or the new revenue recognition approach in HKFRS 15, this article begins with background information on:

- Specific facts and circumstances in Hong Kong relating to pre-completion sales; and
- Five steps that have to be followed when recognizing revenue under HKFRS 15.

### Specific facts and circumstances in Hong Kong

In Hong Kong, the sale and purchase agreements used by various developers are standardized to a large extent. The assessment in this article is based on the standard sale and purchase agreement (which is available on the website of the Law Society of Hong Kong), the legal and regulatory environment, and other specific facts and circumstances in Hong Kong (which may be different from that in other jurisdictions).

In particular, typically in Hong Kong the construction activity relating to multi-storey apartment blocks is at an advanced stage before the

developer enters into any pre-completion sales agreements with retail customers, and the financial ability of the developer to complete that construction activity is not generally dependent on the success of that pre-completion sales programme.

When a customer decides to buy a particular apartment or unit from a developer before the construction is complete, the customer will usually first enter into a preliminary agreement for sale and purchase (PASP) with the developer. The PASP constitutes a legally enforceable contract. It generally specifies the property to be delivered, the consideration, the date of completion of the sale and purchase, and a payment schedule if payment is to be effected by instalments.

According to the Residential Properties (First-hand Sales) Ordinance, at the time of signing the PASP, the customer is required to pay a deposit of 5 percent of the purchase price. In order for the purchase to proceed further, the customer is required to enter into a formal agreement for sale and purchase (ASP) with the developer that supersedes the PASP within five days of signing the PASP. The ASP will contain more





detailed terms governing the sale and purchase than the PASP. If the customer fails to enter into the ASP then the PASP agreement is terminated, the customer forfeits the initial deposit and the developer does not have any further claim against the customer for the failure to enter into the ASP.

As mentioned above, the analysis in this article is based on the standard ASP. The terms of the standard ASP that are relevant in addressing the above two questions include the following:

*Terms relating to the promise for the developer to sell and the customer to purchase the unit*

- A specific apartment or unit is identified in the ASP.
- The ASP states that the developer shall complete construction of the property within a specified period of time.
- The property remains at the developer's risk (mainly physical risk) until the completion of the ASP (i.e. until the time when the property is legally assigned to the customer and the customer obtains vacant possession of the property from the developer).
- Within a certain period of time after the physical completion of the building, the developer shall notify the customer that it is in a position to deliver vacant possession of the property and to assign legal title to the property. From a legal perspective, the ASP is regarded as completed at the time of assignment of the property when vacant possession is delivered at the same time by the passing of keys to the apartment or unit.
- The ASP also specifies when payments have to be made by the customer based on a mutually agreed payment schedule between the developer and the customer. Typically the final payment is to be made by the customer no later than on completion of the ASP contract, i.e. at the point when



vacant possession of the completed property and its keys are transferred to the customer.

*Terms relating to the cancellation or breach of the contract*

- The ASP specifies that it can be cancelled only when both the customer and developer agree to do so (effectively the customer does not have the right to cancel the ASP). In the case when both the customer and developer agree to cancel the contract, the developer has the right to retain 5 percent of the total purchase price and the customer shall bear the legal and transaction costs incidental to the cancellation.
- Should the customer fail to observe or comply with any of the terms or conditions set out in the ASP (e.g. failing to effect payments in accordance with the ASP), the developer may give written notice to the customer calling upon the customer to make good the default first. If the customer fails to do so within 21 days, the developer may give a further written notice to determine the agreement, and in such event:
  - The customer forfeits the sum(s) paid by way of preliminary deposit; and
  - The developer is entitled to either retain the property or re-sell the property either by public auction or private contract. The developer can seek to recover any deficiency in price and all expenses relating

to such resale from the customer, but only if the property is resold within six months of the date of determining the agreement. Any increase in price on a resale belongs to the developer.

Alternatively, the ASP also provides an underlying right under the law for developers to take legal action against customers for specific performance of the contract.

**Overview of the five steps that have to be followed when recognizing revenue under HKFRS 15**

HKFRS 15 introduces a five-step model. This five-step model has been analyzed below in the context of pre-completion sales:

**Step 1: Identify a contract with a customer**

Developers are required to identify who is the customer and whether there is a contract. The PASP is considered to be a "contract", as it is a legally binding document. The subsequent ASP contains more detailed terms and supersedes the PASP when the customer executes the ASP within five working days after the date on which the PASP is entered into. Therefore, in most cases the contract inception date in the context of the HKFRS 15 is the time when the PASP is entered into.

**Step 2: Identify separate performance obligations within a contract**

Developers are required to determine whether a contract with a customer contains more than one performance obligation. For sales of residential units in multi-storey buildings in Hong Kong, the land and building elements of each unit (i.e. the obligation to complete the construction and assign the right to occupy a specified apartment unit in the building together with the associated undivided interests in the land on which the building is



constructed) would generally be considered as a single performance obligation. There may be other performance obligations identified from a full assessment of all terms and conditions of the contract. However, for the purposes of this article the assumption is that other performance obligations are not material.

### Step 3: Determine the transaction price

Developers are required to determine the transaction price of the contract. The transaction price is the consideration for the apartment unit, which is fixed and will be clearly stated in both the PASP and ASP. Generally issues only arise at Step 3 if there is a significant difference between the timing of when the payments are made by the customer and the timing of revenue recognition by the developer. This issue is outside the scope of this article.

### Step 4: Allocate the transaction price to the separate performance obligations

Developers are required to allocate the transaction price identified in Step 3 to each performance obligation identified in Step 2. As the focus of this article is on the recognition of revenue from the single performance obligation (i.e. in Step 2 of this article, it is assumed that any other performance obligations are immaterial), the question of allocation is not addressed in this article.

### Step 5: Determine when consideration allocated to each separate performance obligation should be recognized, being at a particular point in time or over time

Developers are required to determine how their performance obligations iden-

tified in Step 2 are satisfied. This step is critical to determining the answer to the first question addressed in this article: "should developers recognize consideration as revenue at a point in time or over time?". HKFRS 15 is clear that it is not an accounting policy choice. Instead, HKFRS 15 requires that revenue for any given contract be recognized over time when any one or more of the criteria below is met [HKFRS 15.35]:

- a. The customer simultaneously receives and consumes the benefits provided by the developer's performance as the developer performs.
- b. The developer's performance creates or enhances an asset (e.g. work in progress) that the customer controls as the asset is created or enhanced.
- c. The developer's performance does not create an asset with an alternative use to the developer and the developer has an enforceable right to payment for performance completed to date.

If none of these criteria are met, then the revenue must be recognized at a point in time [HKFRS 15.32].

### Analysis of Question 1: Should developers recognize consideration as revenue at a point in time or over time?

As mentioned in Step 5 of the new revenue model above, developers must consider whether revenue will be recognized over time or at a point in time. The criteria for determining whether revenue should be recognized over time as set out in Step 5 above is assessed as follows:

Criterion (a) relates typically to services provided directly to the customer over a period of time (such as outsourcing agreements) and is clearly not

relevant to pre-completion sales.

Criterion (b) typically includes construction activities that may previously be scoped under HKAS 11, such as engaging a contractor to redevelop an office building on land already owned by the customer.

It may also be relevant to residential real estate transactions, such as house and land packages where the title to the land is transferred to the customer at the start of the construction, and the land and house are considered two separate performance obligations – in this case, the customer has direct rights to the construction work-in-progress of their house throughout the construction period.

However, in the case of the construction of a multi-unit apartment building, the connection between the customer and the unit they are purchasing is much less clear during the construction period – most obviously, customers do not obtain physical possession of or access to their particular unit until the construction of the whole building is completed.

Accordingly, in determining whether a developer in Hong Kong should recognize revenue on pre-completion sales at a point in time or over time, the focus should be on criterion (c).

For revenue to be recognized over time, criterion (c) requires:

- (i) The specified apartment unit that is being created to have no alternative use to the developer; and
- (ii) The developer to have enforceable right to payment for performance completed to date.

**Criterion (c)(i) — Does the specified apartment unit that is being created have no alternative use to the developer?**

**Analysis**

HKFRS 15.36 states: "An asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state for another use. The assessment of whether an asset has an alternative use to the entity is made at contract inception. After contract inception, an entity shall not update the assessment

of the alternative use of an asset unless the parties to the contract approve a contract modification that substantively changes performance obligation."

In assessing whether the developer is able to direct the asset to another customer, developers do not consider the possibility of a contract termination [HKFRS 15.IE85].

As mentioned earlier in this article, from the time of entering into the PASP the developer is contractually restricted from re-selling the apartment unit to another customer, provided that the customer does

not default. The developer is also practically restricted from substituting another apartment without the customer's knowledge, as each apartment will be uniquely identified, such as "apartment B on the 16th floor of Block A."

**Conclusion**

It is clear that, contractually, the specified apartment unit that is being created has no alternative use to the developer, once the contract is entered into.

Accordingly, criterion (c)(i) for recognizing revenue over time is met.

**Criterion (c)(ii) — Does the developer have an enforceable right to payment for performance completed to date?**

**Analysis**

In assessing whether a developer has an enforceable right to payment for performance completed to date, HKFRS 15 requires the entity to consider not only the terms of the contract but also any laws that apply to the contract [HKFRS 15.37]. Specifically, developers should consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. This would include an assessment of whether [HKFRS 15.B12]:

- a. Legislation or legal precedent confers to a developer the right to payment for performance to date even though that right is not specified in the contract with the customer;
- b. Relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect; and
- c. A developer's customary business practices of choosing not to enforce a right to payment has resulted in the right being rendered as unenforceable in that legal environment. However,

notwithstanding that a developer may choose to waive its right to payment in similar contracts, a developer would continue to have a right to payment to date if, in the contract with the customer, its right to payment for performance to date remains enforceable.

For a developer to have a right to payment for the performance completed to date, HKFRS 15 states that, at all times throughout the contract starting from the date of contract inception, the developer must be entitled to an amount that at least compensates the developer for performance completed to date if the contract is terminated by the customer or another party for reasons other than the developer's failure to perform as promised [HKFRS 15.37 and 15.B9].

Further, a developer shall consider whether it would have an enforceable right to continue to transfer to the customer the apartment unit promised in the contract and to require the customer to pay the promised consideration even when the customer fails to perform its obligations [HKFRS 15.B11].

With due consideration of the above

guidance, it is important to determine the following two questions:

- 1. Does the agreed payment schedule set out in the contract give the developer an enforceable right to payment for performance completed to date at all times throughout the contract from the date of contract inception?

As mentioned in Step 1 of the new revenue model, the contract inception of pre-completion sales in the context of HKFRS 15 is generally at the time when the PASP is entered into. As mentioned earlier in this article, it is common that the developer has already carried out a substantial proportion of the building activity by the time the customer enters into the PASP contract.

The table on the next page outlines two common payment schedules adopted in Hong Kong concerning pre-completion sales and the analysis of whether the agreed payment schedule gives the developer an enforceable right to payment for performance completed to date at all times throughout the contract from the date of contract inception (i.e. since the time when the PASP is entered into):

Common payment schedules	Analysis
<p><i>Scenario 1:</i> 5 percent of the consideration is payable when the PASP is entered into; another 5-10 percent is paid when the ASP is entered into; and the remaining consideration is payable on completion of the contract when the property is ready for assignment and physical possession of the unit can be delivered.</p>	<p>Since no further consideration is paid from the date of the ASP until completion of the whole building, it is clear that the payment terms do not at all times throughout the contract give the developer an enforceable right to payment for performance completed to date.</p>
<p><i>Scenario 2:</i> 5 percent of the consideration is payable when the PASP is entered into; another 5-10 percent is paid when the ASP is entered into; and the remaining consideration is payable a few months (typically about 3-6 months) after the ASP is entered into in order to be entitled to a discount compared to the price payable under the contract described in Scenario 1.</p>	<p>The analysis in Scenario 2 is the same as in Scenario 1 even though the customer may settle the full amount payable well in advance of the completion of the property. This is because there is a period of 3-6 months during which time the amount paid is incommensurable to the stage of completion of the property. Therefore the payment terms of Scenario 2 do not at all times throughout the contract from the date of contract inception give the developer an enforceable right to payment for performance completed to date.</p>

In conclusion, in both these cases, the payment schedule does not at all times throughout the contract give the developer an enforceable right to payment for performance completed to date.

2. Assuming the contract was terminated before completion for reasons other than the developer's failure to perform as promised (e.g. when a customer defaults on payments when due), does the developer have an enforceable right to require the customer to complete the contract by taking possession of the property and by paying the agreed consideration?

In this regard, although the developer is not precluded under the ASP from seeking to enforce the contract legally, this is not sufficient to conclude that the developer has an "enforceable" right for specific performance within the meaning of HKFRS 15 for the

following reasons:

- If the developer pursues to bring the case to court for specific performance under the common law system, the court will have sole discretion as to whether or not to grant an order for specific performance (an equitable remedy) in favour of the developer, taking into account the specific facts and circumstances of each case. Generally, where damages (i.e. money compensation) would be a sufficient remedy, the courts will be loath to grant relief in terms of an order for specific performance forcing the defaulting customer to complete the sale and purchase.
- Because of the uncertainty created by the court's sole discretion, the usual alternative recourse that developers take is to secure a new customer and to seek compensation from the defaulting customer for any deficiency in price upon re-sale

in accordance with the terms of the ASP, rather than to take legal action against the defaulting customer for specific performance of the contract.

### Conclusion

Taking into account customary practice within the industry, and the high uncertainty in the granting of the equitable relief of specific performance in favour of developers, it is considered that in the case of a pre-completion sales under a standard ASP contract, developers in Hong Kong do not have an enforceable right to payment for performance completed to date within the meaning of HKFRS 15.

Accordingly, criterion (c)(ii) for recognizing revenue over time is not met.

This conclusion might not be applicable to contracts of other industries or other territories. Management will need to evaluate the facts and circumstances in those industries/territories.

### Summary and conclusion on Question 1

As stated at the outset of this analysis on Question 1, HKFRS 15 requires that, if a contract satisfies any one or more of the criteria in HKFRS 15.35, then revenue from that contract must be recognized over time as the developer performs. If, however, the contract satisfies none of the criteria then revenue must be recognized at the point in time at which the developer fully satisfies the performance obligation by transferring control of the asset to the customer

[HKFRS 15.31 and 15.35].

In this analysis we have discussed how a typical contract of pre-completion sales entered into by a developer in Hong Kong fails to satisfy any one of these criteria. Specifically, we have concluded that in these contracts typically:

- a. The customer does not simultaneously receive and consume the benefits provided by the developer's performance as the developer performs;
- b. The developer's performance does

not create or enhance an asset (e.g. work in progress) that the customer controls as the asset is created or enhanced; and

- c. While the developer's performance does not create an asset with an alternative use to the developer, the developer does not have an enforceable right to payment for performance completed to date.

Given this, the conclusion of this article is that consideration from pre-comple-



tion sales under standard ASP contracts in Hong Kong with typical payment terms should not be recognized as revenue until the point in time at which the developer fully satisfies the performance obligation.

### Analysis of Question 2: At which particular point in time should developers in Hong Kong recognize consideration as revenue?

HKFRS 15.31 requires that the point in time when consideration should be recognized as revenue should be when a customer obtains control over the promised asset. "Control" is defined in HKFRS 15.33 as "the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset."

HKFRS 15.33 also states that "control includes the ability to prevent others from directing the use of, and obtaining the benefits from an asset." HKFRS 15.38 contains a number of indicators that help developers determine when control over the promised property has been transferred to the customer, including:

- a. Whether the developer has a present right to payment for the property.
- b. Whether the customer has legal title to the property.
- c. Whether the developer has transferred physical possession of the property to the customer.
- d. Whether the customer has the significant risks and rewards of ownership of the property.
- e. Whether the customer has accepted the property.

Although the above indicators are

similar to the criteria set out in HKAS 18.14 for recognizing revenue from sale of goods, under HKFRS 15 the focus may be different, in that, under HKFRS 15 the focus should be on identifying the point in time when there is a change from the customer's perspective in terms of their ability to access the property and/or otherwise assert their control over it.

Applying this to pre-completion sales agreements, it is noted that based on the specific facts and circumstances in Hong Kong, customers do not have legal title to or physical possession of the property until the property is assigned to the customer and the ASP is completed. This is typically the point in time when the customer pays any outstanding instalments of the consideration price, physically obtains the keys to the unit and, as a result, is able for the first time:

- a. To prevent others from entering the property without their consent;
- b. To pass the keys to his/her own designated fit-out contractor e.g. for lighting etc.; and/or
- c. To occupy the property or arrange for others to occupy it (such as family or tenants) if sufficient basic fixtures and fittings have been pre-installed by the developer.

In other words, at this point in time there is clearly a transfer of control over the property from the developer to the customer and therefore we would expect that in most cases this is the appropriate point in time for the developer to judge that it has satisfied its performance obligation under HKFRS 15.

If this point in time is materially different from the point in time identified for the purposes of HKAS 18, then it may be necessary in the year of first time adoption of HKFRS 15 to restate comparatives and opening balances in order to adopt the new policy retrospectively.

### Other issues to consider

In addition to the issues described above, developers will need to consider other aspects of HKFRS 15 relevant to their activities. For example:

- How the costs to obtain a contract (e.g. the commissions to real estate agents) should be accounted for?
- Whether early payments before delivery of possession of the properties or deferred payments after delivery of possession of the properties contain any significant financing component and hence should be accounted for separately?

These questions are outside the scope of this article but will be addressed separately in later articles by the Institute.



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